

APPEALS SETTLEMENT GUIDELINES

ISSUE: I.R.C. § 41(b) Research Credit -
Qualified Research Expenses-
Extraordinary Expenditures for Utilities

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Qualified Research Expenses- Extraordinary Expenditures for Utilities UIL 41.51-01

STATEMENT OF ISSUE

Whether amounts incurred by a taxpayer for utilities expenses in buildings in which qualified research was conducted ("Research Buildings") are qualified research expenses as defined in I.R.C. § 41(b).

BACKGROUND

Taxpayers who have incurred utility expenses, such as water, electricity and natural gas in the Research Buildings have claimed such amounts as qualified research expenses under I.R.C. § 41. These taxpayers rely on Treas. Reg. § 1.41-2(b)(2)(ii) which provides that to the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures are treated as amounts paid or incurred for supplies used in the conduct of qualified research.

COMPLIANCE POSITION

Under Treas. Reg. §§1.41-2(b)(1) and (b)(2)(i), the general rule is that when qualified research is conducted, utility expenses are treated as general and administrative expenses and therefore do not qualify as in-house research expenses as defined in I.R.C. § 41(b).

Pursuant to Treas. Reg. § 1.41-2(b)(2)(ii), to the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research as defined in I.R.C. § 41(b).

TAXPAYER POSITION

Taxpayers argue that because utility expenses incurred in the Research Buildings exceeded the per square foot utilities expenses in buildings where qualified research was not performed ("Non-Research Buildings"), the incremental cost of providing utilities

to the Research Buildings over the corresponding costs of providing utilities to the Non-Research Buildings is a qualified research expense eligible for the credit under I.R.C. § 41.

DISCUSSION

Facts

As presented in Compliance's Coordinated Issue Paper (CIP) and observed in Appeals, some taxpayer's per square foot utilities expenses in their Research Buildings exceeded the per square foot utilities expenses in their Non-Research Buildings. In computing the research credit, taxpayers included certain amounts incurred for utilities used in the Research Buildings. Taxpayers used the following methodology to determine these amounts:

Step 1: Taxpayers determined their utilities expenses per square foot in the Non-Research Buildings.

Step 2: Taxpayers determined their utilities expenses per square foot in the Research Buildings.

Step 3: Taxpayers subtracted the per square foot utilities expenses for the Non-Research Buildings from the per square foot utilities expenses for the Research Buildings.

Step 4: Taxpayers multiplied the difference by the number of square feet in the Research Buildings to determine the utilities expenses for the Research Buildings included as qualified research expenses.

Taxpayers treated the incremental cost of providing utilities to the Research Buildings over the corresponding costs of providing utilities to the Non-Research Buildings as qualified research expenses eligible for the credit under I.R.C. § 41.

Law

I.R.C. § 41(a) provides a credit against tax for increasing research activities (research credit). The research credit is equal to the sum of: (1) 20 percent of the excess (if any) of the taxpayer's qualified research expenses for the taxable year over its base amount, (2) 20 percent of the basic research payments determined under I.R.C. § 41(e)(1)(A), and (3) 20 percent of the amounts paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer during the taxable year (including as contributions) to an energy research consortium for energy research.

I.R.C. § 41(b)(1) defines the term "qualified research expenses" to include in-house research expenses and contract research expenses.

I.R.C. § 41(b)(2)(A)(ii) provides that the term "in-house research expenses" includes any amount paid or incurred for supplies used in the conduct of qualified research.

I.R.C. § 41(b)(2)(C) defines the term "supplies" to mean any tangible property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation.

Treas. Reg. § 1.41-2(b)(1) provides, in relevant part, that expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as in-house research expenses.

Treas. Reg. § 1.41-2(b)(2)(i) provides that, in general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

Treas. Reg. § 1.41-2(b)(2)(ii) provides that to the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

SETTLEMENT GUIDELINES

Overview

As a general rule, expenditures for utilities such as water, electricity and natural gas used in a building in which qualified research is performed are treated as general and administrative expenses and do not qualify as qualified research expenses under I.R.C. § 41(b). See Treas. Reg. § 1.41-2(b)(2)(i). The one exception to this general rule is contained in Treas. Reg. § 1.41-2(b)(2)(ii) dealing with "extraordinary expenditures" for utilities.

On May 9, 2006, Compliance issued a Coordinated Issue Paper ("CIP") in which it described a methodology used by some taxpayers to compute the incremental cost of providing utilities to the Research Buildings and where taxpayers treated the incremental cost of the utilities as qualified research expense for purposes of I.R.C. § 41. After analyzing I.R.C. § 41, its legislative history and Treas. Reg. §§ 1.41-2(b)(2)(i)

and (ii), Compliance concluded that the taxpayers had not satisfied the requirements of Treas. Reg. § 1.41-2(b)(2)(ii) therefore, the incremental utilities expenses were not qualified research expenses for purposes of I.R.C. § 41(b).

Legislative History

Following is an excerpt from H.R. Rep. No. 97-201, at 118 (1981) addressing in-house research expenditures and the criteria that is applied in determining whether they can be classified as "supplies used in the conduct of qualified research":

The second category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for supplies used in the conduct of qualified research. The provision defines the term "supplies" to mean any tangible property other than (a) land or improvements to land or (b) property of a character subject to the allowance for depreciation. Property which is of a character subject to the depreciation allowance is not eligible for the credit whether or not amounts of depreciation are deductible during the year and whether or not the cost of such property can be "expensed."

The final category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for the right to use personal property in the conduct of qualified research, if such amounts are paid to a person other than the taxpayer. Intercompany charges for the right to use personal property in the conduct of research are not eligible for the credit.

Determinations of whether and to what extent research expenditures of a taxpayer qualify under the second or third categories of in-house research expenditures are to be made in accordance with the rules, described and illustrated above, applicable in determining whether and to what extent wage expenditures qualify for the credit. Thus, for example, the credit is not available for expenditures for supplies, or for the use of personal property, if such expenditures constitute indirect research expenditures, or if such expenditures constitute or are part of general and administrative costs or overhead costs (such as utilities).

Treasury Regulations

General Rule:

Treas. Reg. § 1.41-2(b)(2)(i) provides that, in general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

Exception to General Rule:

A limited exception to the general rule set forth in Treas. Reg. § 1.41-2(b)(2)(i) is found in Treas. Reg. § 1.41-2(b)(2)(ii) which provides that to the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. Thus, to qualify for this limited exception, a taxpayer must establish the following:

- (1) that the qualified research is of a "special character,"
- (2) that the special character of the qualified research "required" the utilities expenses, and
- (3) that the required utilities expenses are both "additional" and "extraordinary."

Treas. Reg. § 1.41-2(b)(2)(ii) provides, in relevant part, the following example to illustrate this limited exception:

[A]mounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

The law provides that a taxpayer's utilities expenses are general and administrative expenses not included in the computation of the research credit, unless the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities.

Settlement Position

Appeals Officers/ATCLs should keep in mind the general rule found in Treas. Reg. § 1.41-2(b)(2)(i) which specifically provides that amounts paid or incurred for utilities such as water, electricity and natural gas used in a building in which qualified research is performed are treated as general and administrative expenses that do not qualify as qualified research expenses for purposes of the research credit.

To qualify for the extraordinary expenditure exception in Treas. Reg. § 1.41-2(b)(ii), a taxpayer must establish:

- (1) Qualified research is of a "special character",
- (2) The special character of the qualified research "required" the utilities expenses and
- (3) Required utilities expenses are both "additional" and "extraordinary."

Accordingly, utilities expenses qualify only if they are extraordinary additional expenses necessitated by the special character of the research being conducted by the taxpayer.

Conclusion and Recommendation:

Appeals concurs with the analysis of the statute, the legislative history and the Treasury Regulations performed by Compliance in the CIP.

While the method used by taxpayers in the CIP establishes that on a square foot basis additional utilities were consumed in the Research Buildings, it does not establish that the additional utilities were actually used in the conduct of qualifying research. In order to treat the additional utilities as qualified research expenses, the taxpayer must establish that they were actually used in the conduct of qualifying research and meet the requirements found in Treas. Reg. § 1.41-2(b)(2)(ii). See I.R.C. § 41(b)(2)(A)(ii) and Lockheed Martin Corp. v. United States, 49 Fed. Cl. 241 (2001). Therefore, the incremental approach used by taxpayers does not satisfy the requirements of the statute or regulations.

Treas. Reg. § 1.41-2(b)(2)(ii), makes it clear that only in very limited and specific situations will utility expenses be allowed to be treated as a qualified research expense pursuant to I.R.C. § 41(b). Therefore, Compliance's position should be sustained unless the taxpayer can establish that it incurred additional extraordinary utilities expenses that were required by the special character of the research it was conducting.